

**Ketua Pengarah Hasil Dalam Negeri v
James Armand Menezes**

HIGH COURT (KUALA LUMPUR) — CASE NO R2-14-11 OF 1998
AZMEL J
8 JUNE 2000

Revenue Law — *Income tax* — *Capital versus income* — *Retirement of partner* — *Payment of retired partner's share of profit made in instalments* — *Payment termed as 'consultancy payment' in settlement agreement* — *Whether payments were actually income*

The respondent had been a partner of an accounting firm since 1 July 1981. In accordance with the terms of a settlement agreement, the respondent retired as a partner of the firm with effect from 31 July 1990. It was a term of the settlement agreement that the respondent would receive payments in accordance with paras 2 and 3 of the settlement agreement. Paragraph 3 provided for 'consultancy payment payable by way of 23 instalments commencing 31 August 1990 and concluding 30 June 1992'. After his retirement from the firm, the respondent was employed as a consultant of the firm with effect from 1 August 1990 to 30 June 1992. For the year of assessment 1991, the respondent was named as a partner of the firm. However by a letter dated 7 May 1993, the respondent objected to the appellant concerning the inclusion of the respondent as a partner of the firm for year of assessment 1991 as well as the second half of the year 1990. The respondent claimed that the sum received under para 3 of the settlement agreement was not income but capital. The matter was referred to the special commissioners for income tax for their ruling. The special commissioners held that the payments under para 3 of the settlement agreement were not income but capital and thus not taxable under the Income Tax Act 1967. The appellant appealed.

Held, dismissing the appeal:

- (1) The court agreed with the special commissioner that the 23 equal instalments paid to the respondent from 31 August 1990 to 30 June 1992 was only the method of payment. The quantum of the payment to the respondent was based on an already known figure, ie the share of the respondent's profit for the year ended 31 December 1989. Due to financial constraint of the firm, the payment could not be made in one lump sum. The fact that the payments were made by instalments which went up to 30 June 1992 did not change its character (see pp 584G–585A).

- (2) From the wordings of para 3, it was quite true that both parties were very concerned as regards their tax liabilities. But this was just a question of concern of the parties. Such concern could not be regarded as unusual. The content of para 3 was intended mainly to serve as a reminder to both parties and be prepared when they subsequently faced the tax authorities in respect of such payments (see p 585G).

- (3) The special commissioners had arrived at the right decision to say that the entry in the tax returns for the first half year 1990 and 1991 stating that the respondent was a partner of the firm was a genuine mistake. He could no longer be a partner after he had retired as clearly stated in the settlement agreement (see p 585H).

[Bahasa Malaysia summary]

Responden adalah rakan kongsi suatu firma perakaunan sejak 1 Julai 1981. Menurut terma-terma perjanjian penyelesaian, responden telah bersara sebagai rakan kongsi mulai 31 Julai 1990. Ia adalah suatu terma perjanjian penyelesaian bahawa responden akan menerima pembayaran-pembayaran menurut perenggan 2 dan 3 perjanjian penyelesaian tersebut. Perenggan 3 memperuntukkan 'pembayaran pakar runding dibayar secara 23 ansuran mulai 31 Ogos 1990 dan tamat pada 30 Jun 1992'. Selepas persaraannya daripada firma, responden telah digaji sebagai pakar runding firma tersebut mulai 1 Ogos 1990 sehingga 30 Jun 1992. Bagi tahun penaksiran 1991, responden telah dinamakan sebagai rakan kongsi firma tersebut. Namun melalui suatu surat bertarikh 7 Mei 1993, responden telah membantah terhadap perayu berkenaan kemasukan responden sebagai rakan kongsi firma tersebut untuk tahun penaksiran 1991 dan juga tempoh separuh kedua tahun 1990. Responden mendakwa bahawa jumlah yang diterima di bawah perenggan 3 perjanjian penyelesaian bukanlah gaji tetapi modal. Perkara tersebut telah dirujuk kepada pesuruhjaya khas untuk cukai pendapatan untuk keputusan mereka. Pesuruhjaya khas memutuskan bahawa pembayaran-pembayaran di bawah perenggan 3 perjanjian penyelesaian bukanlah gaji tetapi modal dan dengan itu tidak boleh dicukaikan di bawah Akta Cukai Pendapatan 1967. Perayu telah merayu.

Diputuskan, menolak rayuan tersebut:

- (1) Mahkamah bersetuju dengan pesuruhjaya khas bahawa bayaran 23 ansuran yang sama kepada responden dari 31 Ogos 1990 sehingga 30 Jun 1992 hanyalah merupakan cara pembayaran. Jumlah pembayaran kepada responden adalah berdasarkan kepada jumlah yang telah pun diketahui, iaitu bahagian keuntungan responden untuk tahun berakhir 31 Disember 1989. Oleh kerana bebanan kewangan firma tersebut, pembayaran tersebut tidak boleh dibuat sekaligus. Hakikat bahawa pembayaran-pembayara dibuat secara ansuran sehingga 30 Jun 1992 tidak mengubah bentuknya (liha ms 584G-585A).
- (2) Daripada perkataan-perkataan perenggan 3, adalah benar bahawa kedua-dua pihak amat ambil berat berkenaan liabiliti cukai mereka. Tetapi ini hanyalah persoalan keprihatinan pihak-pihak

- A sahaja. Keprihatinan tersebut tidak boleh dianggap sebagai luar biasa. Kandungan perenggan 3 berniat untuk mengingatkan kedua-dua pihak dan supaya bersedia apabila berdepan dengan pihak berkuasa cukai berkenaan pembayaran-pembayaran sedemikian (lihat ms 585G).
- B (3) Pesuruhjaya khas telah mencapai keputusan yang betul dalam mengatakan kemasukan di dalam penyata cukai untuk tempoh separuh pertama tahun 1990 dan 1991 yang menyatakan bahawa responden adalah rakan kongsi firma adalah kesilapan yang benar. Beliau tidak boleh menjadi rakan kongsi lagi selepas beliau bersara seperti yang dinyatakan dengan jelas di dalam perjanjian penyelesaian (lihat ms 585H).]
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Notes

For cases on capital versus income, see 10 *Mallal's Digest* (4th Ed, 1996 Reissue) para 1748-1749.

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Cases referred to

Commissioners of Inland Revenue v Fleming & Co (Machinery Ltd)
33 TC 57 (refd)

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Paget v Commissioner of Inland Revenue 21 TC 677 (refd)
Sun Newspapers Ltd v FC of T [1938] 16 CCR 337 (refd)
Van Den Berghs v Clark (HM Inspector of Taxes) 19 TC 390 (refd)

Legislation referred to

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Income Tax Act 1967 s 4
Partnership Act 1961 ss 21, 44

Hazlina Hussain (Legal Officer, Inland Revenue Board) for the appellant.

A Subramaniam (Shook Lin & Bok) for the respondent.

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Azmel J: The respondent, James Armand Menezes, an accountant by profession, had been a partner of the accounting firm Ernst & Whinney since 1 July 1981. Subsequently when Ernst & Whinney decided to merge with another accounting firm, Ernst & Young (M) the respondent together with two other partners of Ernst & Whinney objected. Despite the objection

H the merger between the two accounting firms went ahead. The merger came into effect on 1 July 1990. However a settlement was reached between Ernst & Whinney and the three opposing partners including the respondent. This settlement came in the form of a letter addressed to the three partners stating the terms of the settlement, dated 31 July 1990. All the three partners including the respondent accepted the terms of the settlement.

I In accordance with the terms of the settlement agreement the respondent retired as a partner of the firm wef 31 July 1990. He was then 44 years old, 11 years before the normal retirement age of 55. It was also a term of the

settlement agreement that the respondent would receive payments in accordance with paras 2 and 3 of the said settlement agreement, which state:

- (2) It is agreed you will receive and you will participate in the profits for the six months to 30 June 1990 which will be calculated in accordance with your profit sharing entitlements for that period and these entitlements will be credited to your current accounts and be interest bearing from that date. These balances will be paid to you in two installments as at the end of September and December 1990 after taking account of your drawings post 30 June 1990.
- (3) It is agreed you will each receive additional payments calculated as per the appended schedule payable by way of 23 installments commencing 31 August 1990 and concluding 30 June 1992. These payments will be recorded in the firm's books as consultancy payments and in the case of the Singapore and Malaysian firms you will be responsible for meeting your respective tax liabilities on same subject to the point that the method of recording the payments and the descriptive terminology applied to them may require to be varied to ensure tax deductibility on the part of the firm. In the case of the Hong Kong firm tax will be withheld at the rate of 15% until the Hong Kong Tax structure has been agreed and the firm will be pleased to assist you to put in place the most effective tax planning arrangements in this regard.

This payment by way of the 23 installments amounting to a sum of RM1,240,816 as mentioned in para 3 of the settlement agreement dated 31 July 1990 became the main issue in the case, ie whether the amount received by the respondent should be regarded as 'income' or 'capital' within the meaning of s 4 of the Income Tax Act 1967. On the payments that were received by the respondent in the year of assessment 1991 (amounting to RM280,879) and in 1992 (amounting to RM980,073) making a total amount of RM1,260,952 the appellant decided to levy tax on it as the appellant regarded the payment as income. It must be pointed out that out of the sum of RM1,260,952 a certain amount of non-tax deductible adjustments amounting to RM20,136 had also been included by Ernst & Young. Hence the net amount actually paid in accordance with para 3 of the settlement agreement was RM1,240,816. Since the respondent claimed that the said sum was not income but capital received, the matter was referred to the Special Commissioners for Income Tax for their ruling. After the hearing the Special Commissioners handed down their deciding order dated 10 September 1998 as follows:

ADALAH DIPUTUSKAN bahawa amaun sebanyak RM1,260,952.00 yang diterima oleh Perayu merupakan penerimaan modal dan oleh itu tidak boleh dikenakan cukai dibawah Akta Cukai Pendapatan 1967.

It was against this order of the Special Commissioners that this appeal was made by the appellant.

The relevant provision of the Income Tax Act 1967 on this issue is s 4 which reads:

- A** Subject to this Act, the income upon which tax is chargeable under the Act is income in respect of —
- (a) gains or profits from a business, for whatever period of time carried on;
 - (b) gains or profits from an employment;
 - (c) dividends, interest or discount;
- B** (d) rents, royalties or premium;
- (e) pensions, annuities or other periodical payments not falling under any of the foregoing para;
 - (f) gains or profits not falling under any of the following paras.
- C** Other provisions of law which I consider to be of certain relevance are s 21 and s 44 of the Partnership Act 1961 which read:
- 21 Variation by Consent of Terms of Partnership
- The mutual rights and duties of partners, whether ascertained by agreement or defined by this Act, may be varied by the consent of all the partners, and such consent may be either express or inferred from a course of dealing.
- D**
- 44 Rights of Outgoing Partner in Certain Cases to Share Profits Made After Dissolution
- Where a member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with its capital or assets without any final settlement of accounts as between the firm and the outgoing partner or his estate, then, in the absence of any agreement to the contrary, the outgoing partner or his estate is entitled, at the option of himself or his representatives, to such share of the profits made since the dissolution as the court may find to be attributable to the use of his share of the partnership assets, or to interest at the rate of eight per cent per annum on the amount of his share of the partnership assets;
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- F**
- Provided that where, by the partnership contract, an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner or the outgoing partner or his estate as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the preceding provisions of this section.
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- H** In arriving at the decision that the payment of RM1,240,816 by the respondent was capital payment instead of income, the Special Commissioners gave the following reasons:
- (1) The sums paid are withdrawal of capital in respect of goodwill upon retirement;
 - (2) The consideration received was for loss of rights under the deed dated 1 September 1981;
 - (3) Payments that were received was in consideration for refraining from competition with accounting firm.
- I**

In respect of the first reason the Special Commissioners said that the respondent had played key roles in the development of the business and goodwill of the partnership for many years. In addition to that the respondent had made capital contributions to the partnership.

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As to the second reason the Special Commissioners said that the respondent had lost all his rights under the Partnership Deed of Ernst & Whinney dated 1 September 1981. Amongst the rights that the respondent had lost upon accepting the settlement agreement were:

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- (a) claims on the income of various partnerships;
- (b) not being allowed to compete with the partnership or the new partnership; and
- (c) forbidden to take any legal action against the partnership.

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In arriving at the decision that such loss of rights was capital received the Special Commissioners referred to the case of *Van Den Berghs v Clark (HM Inspector of Taxes)* 19 TC 390 quoting the judgment of Lord Macmillan, as follows:

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In my opinion that asset, the congeries of rights which the appellants enjoyed under the agreements and which for a price they surrendered, was a capital asset.

They also referred to the case of *Paget v Commissioner of Inland Revenue* 21 TC 677, where Lord Romer said:

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In these circumstances, the only question to be decided is whether the proceeds of sale of a right to receive income in the future can be treated as income for the purpose of the Income Tax Acts. The question thus broadly stated plainly admits of but one answer, and that answer must be in the negative. The proceeds of the sale for a lump sum of an annuity, for instance, are capital in the hands of the vendor and not income. And this is true even when the subject of the sale is not the annuity for its whole duration, but the right to be paid the annuity for a number of years, or even for one year.

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The Special Commissioners had also referred to several other cases in respect of this issue. As those cases refer to the same principle of law I do not propose to refer to them.

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As regards the third reason the Special Commissioners said that payments received by the respondent to refrain him competing with the partnership business was capital. And in support of this matter the Special Commissioners referred to the case of *Sun Newspapers Ltd v FC of T* [1938] 16 CCR 337.

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It was contended by the appellant that in para 2 of the settlement agreement it was not disputed that the respondent would be paid profits for the six months period beginning 1 January 1990 to 30 June 1990 payable in two installments. In para 3 of the settlement agreement the term 'additional payments' had been defined as 'consultancy payments'. This is not a conclusive term in determining whether it is a deductible item under s 4 of the Income Tax Act 1967. As the respondent had signed and accepted this settlement agreement he therefore must have also agreed that this additional

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- A payment in para 3 to mean 'consultancy payment'. From the wordings of para 3 the respondent must have been fully aware of the actual nature of this 'additional payments' because in this para 3 it is clearly stated that Ernst & Whinney was very concerned not to be subjected to imposition of tax in respect of such payment, to the extent that Ernst & Whinney withheld 15% of the payment in respect of payment from the Hong Kong firm. In the light of the wordings of para 3 of this settlement agreement and having regard to the concern of Ernst & Whinney not to be liable to pay tax it can therefore be concluded that the additional payments received by the respondent under para 3 was income and not capital.

- C In the light of such uncertainty counsel for the appellant urged the court to adhere to the principle enunciated by Lord Russel in the case of *Commissioners of Inland Revenue v Fleming & Co (Machinery Ltd)* 33 TC 57, where his Lordship said:

- D The sum received by a commercial firm as compensation for the loss sustained by the cancellation of a trading contract or the premature termination of an agency agreement may in the recipient's hands be regarded either as a capital receipt or as a trading receipt forming part of the trading profit. It may be difficult to formulate a general principle by reference to which in all cases the correct decision will be arrived at since in each case the question comes to be one of circumstances and degree.

- E I fully subscribe with the above principle and it is on such basis I shall examine whether the Special Commissioners had adopted the proper approach and had considered all the relevant facts and circumstances in handing down their deciding order. Before I do that, allow me to continue with the remaining contention of the appellant.

- F Counsel for the appellant contended that it is the principle of the law of contract that a party who signs an agreement is bound by the terms of the contract unless, of course, the signature is shown to be obtained by fraud or misrepresentation. In asserting that such settlement agreement was signed not on the ground of misrepresentation or fraud, the appellant referred to the letter at p 60 of exh F where the respondent himself wrote to the Managing Director of the firm in reference to the settlement agreement, as follows:

- H Pursuant to cl 3 of the settlement agreement, it is our view that in order to ensure the tax deductibility of the consultancy payment in the books of Ernst & Young, it would be advisable for the firm to enter into a separate consultancy agreement with each of us to cover the period between 1 August 1990 to 30 June 1992. We strongly believe that with this arrangement, there should be no problem faced by the IRD and look forward to receiving from you a draft of the Consultancy Agreement prior to finalisation.

- I It was a proven fact that after his retirement from the firm the respondent was employed as a consultant of the firm Ernst & Young wef 1 August 1990 to 30 June 1992. This was in accordance with para 5 of the settlement agreement. It was also a proven fact that for the year of assessment 1991 the respondent was named as a partner of the firm Ernst & Young (see p 6 of exh F). However by a letter dated 7 May 1993 the respondent objected to

the appellant concerning the inclusion of the respondent as a partner of Ernst & Young for year of assessment 1991 as well as the second half of the year 1990.

Further, in alleging that the payment under para 3 was income and not capital, counsel for the appellant contended that para 3 read together with para 4 of the settlement agreement would confirm such conclusion. Paragraph 4 states:

You will have no claim on the income of the various partnerships of Ernst & Whinney and Ernst & Young other than as described above in paras 2 and 3 except for interest which may accrue on any balances due to you as at 30 June 1990 in respect of your undrawn profits for the six months to 30 June 1990 and in respect of outstanding balances due to you per para 3 as at 31 December 1990 and 31 December 1991.

Those are briefly the contention of the appellant.

In deciding that the payments under para 3 of the settlement agreement received by the respondent was not income but capital received the Special Commissioners gave the following reasons which I fully agree.

There was a clear distinction between the payments under paras 2 and 3. Payments under para 2 are taxable because that para 2 clearly states that the payments for the six months period were the respondent's share of the profit. I do not wish to discuss on this issue in more detail because it is not being disputed except to say that Ernst & Whinney in which the respondent was a partner had ceased to exist after 30 June 1990 since it had merged with Ernst & Young on 1 July 1990.

The issue is in respect of payment in para 3 of the settlement agreement. That payment is called '*consultancy payments*'. What causes para 3 to be confusing is the mention of making payments '*by way of 23 equal installments commencing 31 August 1990 and concluding 30 June 1992*', and calling it as '*consultancy payments*'. And for making such payments the respondent was made a consultant to the firm, Ernst & Young. Confusion was further compounded when Ernst & Young included the respondent as a partner of the firm for income tax return for the year 1991 and the second half of the year 1990. From the facts and circumstances of this case the Special Commissioners concluded that the payments in para 3 were capital and not income and therefore not taxable. The Special Commissioners explained that the 23 equal installments paid to the respondent from 31 August 1990 to 30 June 1992 was only the method of payment. The quantum of the payment to the respondent was based on an already known figure that is the share of the respondent's profit for the year ended 31 December 1989. Due to financial constraint of Ernst & Young the payment could not be made in one lump sum. As such both parties agreed that the payment be made in 23 equal installments. Having regard to the fact that the amount payable was quite substantial, a sum of more than RM1m, coupled with the fact that there were also two other partners whom Ernst & Young also had to pay it would cause the firm great financial embarrassment if the three partners insisted on one lump sum payment. The fact that the payments were made by installments which went up to

- A 30 June 1992 does not change its character. In support of such principle, the Special Commissioners referred to the decision in the case of *Paget v Commissioner of Inland Revenue* that states:

- B The proceeds of the sale of a lump sum of an annuity, for instance, are capital in the hands of the vendor and not income. And this is true even when the subject of the sale is not the annuity for the whole duration, but the right to be paid the annuity for a number of years, or even for a year.

Paragraph 4 of the settlement agreement basically talks about the limit of the payments made under paras 2 and 3. The only exception is the question of interest. Apart from that it has no further links with the payments in paras 2 and 3.

- C Paragraph 5 of the settlement agreement talks of the requirement to enter into the Consultancy Agreement between the firm and the respondent in order to effect the payments under para 3. The letter at p 60 of exh F supports such finding. It is not inconsistent with the intention as alleged by the appellant.

- D As regards para 12, it is quite clear to me that it refers to payment under para 2. It only talks of two matters namely, which period to base the calculation of profit, either 1 January 1990 or 1 July 1990; and that the payment must be made not later than 31 January 1991.

- E As regard para 3 itself, from the wordings it is quite true that both parties especially the firm were very concerned as regards their tax liabilities. But this is just a question of concern of the parties. I do not think such concern can be regarded as unusual. The content of this para 3 was intended mainly to serve as reminder to both parties and be prepared when they subsequently faced the income tax authorities in respect of such payments. As anticipated the parties especially the respondent were in fact asked to pay tax by the tax authorities in respect of the payments. In the circumstances I find myself in full agreement with the finding and conclusion of the Special Commissioners.

- G Finally there was the entry made by Ernst & Young in the tax returns for the first half year 1990 and the year 1991 where the respondent's name appeared as a partner of the firm despite the respondent having signed and accepted the settlement agreement dated 31 July 1990 relinquishing his partnership in the firm. Obviously this is a genuine mistake on the part of the firm to include the respondent's name among the list of its partners. As stated earlier the respondent had written to the appellant to register his objection. In the circumstances I was of the view that the Special Commissioners had arrived at the right decision to say that the entry stating that the respondent was a partner of Ernst & Young was a genuine mistake. He could no longer be a partner after he had retired as clearly stated in the settlement agreement.

- I After having considered all the facts and circumstances of this case including the submissions of counsels of both parties I was unable to find any reason why I should deviate from the deciding order of the Special Commissioners, who had thoroughly considered all the facts and

circumstances of the case at the hearing before them. I therefore dismissed the appeal with costs.

Appeal dismissed.

Reported by Jafisah Jaafar

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